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6 **BEFORE THE ARIZONA CORPORATION COMMISSION**

7
8 IN THE MATTER OF THE
APPLICATION OF ARIZONA-
AMERICAN WATER COMPANY, AN
9 ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT
10 FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR
11 INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR
12 UTILITY SERVICE BY ITS SUN CITY
WEST WATER AND WASTEWATER
13 DISTRICTS.

14 IN THE MATTER OF THE
APPLICATION OF ARIZONA-
AMERICAN WATER COMPANY, INC.,
15 AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT
16 FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR
17 INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR
18 UTILITY SERVICE BY ITS SUN CITY
WATER AND WASTEWATER
19 DISTRICTS.

20 IN THE MATTER OF THE
APPLICATION OF ARIZONA-
AMERICAN WATER COMPANY, AN
21 ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT
22 FAIR VALUE OF ITS UTILITY PLANT
AND PROPERTY AND FOR
23 INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR
24 UTILITY SERVICE BY ITS MOHAVE
WATER AND HAVASU WATER
25 DISTRICTS.
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DOCKET NOS. WS-01303A-02-0867
WS-01303A-02-0868
W-01303A-02-0869
WS-01303A-02-0870
W-01303A-02-0908

(CONSOLIDATED)

ARIZONA-AMERICAN WATER
COMPANY'S REPLY BRIEF

Arizona Corporation Commission
DOCKETED

FEB 18 2004

DOCKETED BY	<i>MP</i>
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1 IN THE MATTER OF THE
2 APPLICATION OF ARIZONA-
3 AMERICAN WATER COMPANY, AN
4 ARIZONA CORPORATION, FOR A
5 DETERMINATION OF THE CURRENT
6 FAIR VALUE OF ITS UTILITY PLANT
7 AND PROPERTY AND FOR
8 INCREASES IN ITS RATES AND
9 CHARGES BASED THEREON FOR
10 UTILITY SERVICE BY ITS ANTHEM
11 WATER, AGUA FRIA WATER AND
12 ANTHEM/AGUA FRIA WASTEWATER
13 DISTRICTS.

14 IN THE MATTER OF THE
15 APPLICATION OF ARIZONA-
16 AMERICAN WATER COMPANY, AN
17 ARIZONA CORPORATION, FOR A
18 DETERMINATION OF THE CURRENT
19 FAIR VALUE OF ITS UTILITY PLANT
20 AND PROPERTY AND FOR
21 INCREASES IN ITS RATES AND
22 CHARGES BASED THEREON FOR
23 UTILITY SERVICE BY ITS TUBAC
24 WATER DISTRICT.
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1 **I. INTRODUCTION.**

2 Arizona-American Water Company, an Arizona corporation, ("Arizona-American"
3 or "the Company") hereby submits its reply brief in support of its application for a
4 determination of the fair value of its utility plant and property and for appropriate
5 adjustments to its rates and charges for utility service. At issue in this proceeding are 10
6 separate districts that provide water or wastewater service to over 120,000 customers in
7 Maricopa, Mohave and Santa Cruz Counties. The specific revenue adjustments being
8 requested are set forth on page 1 of the Company's initial brief and in the schedules
9 attached to Mr. Bourassa's Rejoinder Testimony (Ex. A-24).

10 This reply brief will focus on the arguments presented by the Utilities Division
11 ("Staff"), Residential Utility Consumer Office ("RUCO") and the Town of Youngtown.¹
12 These parties advocate positions that, if adopted, would deprive Arizona-American of an
13 opportunity to earn a reasonable return on the fair value of its property. Very simply, their
14 positions are:

- 15 • The Company's fair value rate base should be based on an average of
16 the historic cost and reproduction cost of its plant, notwithstanding
17 the evidence that the current value of the Company's plant is no less
18 than its reproduction cost.
- 19 • The Company's fair value rate base should not be used to establish its
20 revenue requirement. Instead, the revenue requirement should be
21 based solely on the historic cost of the plant.
- 22 • Approximately \$2 million of plant should be removed from the
23 Company's rate base because it has been taken out of service.
24 However, \$438,000 of accumulated depreciation related to that plant
25 should continue to be deducted from rate base. (Staff only.)
- 26 • Test year operating expenses should not be adjusted to remove
 Citizens Communications' corporate overheads and salaries and

¹ Sun Health Corporation's primary interest is in the rate design for the Sun City and Sun City West districts, and its positions are consistent with the Company. The Arizona Utility Investors Association's primary interests are the development and use of an appropriate fair value rate base and a reasonable rate of return, and is generally aligned with the Company. Frank J. Grimmelman, an Anthem resident who has intervened on his own behalf, generally adopts the positions of Staff and RUCO.

1 wages and bring in the Company's 2002 expenses, even though
2 Citizens' expenses in 2001 (1) will never recur and (2) were
3 abnormal and understated when compared to 1999 and 2000 levels.
4 (Staff only.)

- 5 • The Company's requested amount of rate case expense, \$715,000
6 should not be approved, even though its actual expense exceeds \$1
7 million. (RUCO only.)
- 8 • The rate of return on the rate bases, which are based on the historic
9 cost of the Company's plant, should be only 6.5% (Staff) and 6.77%
10 (RUCO). These rates of return, when applied to Staff's fair value
11 rate bases for each district, actually produce returns that approach or,
12 in some cases, are less than the yields on U.S. Treasury securities.
- 13 • The Company's authorized return on common equity should be only
14 9.0% (Staff) and 9.61% (RUCO), even though the parties' sample
15 group of publicly traded water utilities are currently earning over
16 10% and are projected to earn 11% in 2004.
- 17 • The Company's request for a surcharge mechanism to recover
18 payments to be made to the City of Tolleson for wastewater
19 treatment, which are estimated to cost \$10 million, should be denied,
20 even though there is no dispute that the contract for this service is
21 prudent and cost effective, and the Company has no means of
22 recovering these costs other than filing additional rate cases. (Staff
23 and RUCO.)
- 24 • Staff's three-tier, inverted block rate design should be adopted for all
25 seven Company water districts, even though Staff has admitted this
26 rate design will not cause existing customers to change their water
use patterns, while creating a substantial subsidy that would be
recovered from large commercial customers, such as schools and
hospitals. (Staff only.)
- Rate increases should be phased in over 2 or 3 years, or simply
capped at 20%, regardless of the return on the fair value of the
Company's property. (Youngtown only.)

21 When viewed together, these recommendations would place Arizona-American in
22 a break-even position, i.e., having sufficient cash flow to pay annual interest charges on
23 debt, but little left over to finance plant upgrades and improvements and to pay dividends.
24 Considering that the Commission has also prohibited Arizona-American from filing any
25 new rate applications until 2006 in the absence of an emergency, these recommendations
26 would result in rates that are unjust and confiscatory.

1 **II. RATE BASE ISSUES.**

2 In their initial closing briefs, Staff, RUCO and Youngtown oppose the use of the
3 Company's reconstruction cost new rate base ("RCRB") as the fair value of the
4 Company's utility plant and property. Although these parties offer various arguments for
5 using an original cost rate base ("OCRB") instead, each of them would have the
6 Commission violate the Arizona Constitution by failing to determine and *actually use* the
7 fair value of the Company's utility plant and property in setting rates. Ariz. Const. art. 15,
8 § 14. In a monopoly setting, fair value is the "exclusive rate base" on which a utility's
9 rates are established. *US West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz.
10 242, 244-46, ¶¶ 13-19, 34 P.3d 351, 354-55 (2001).

11 Under the fair value method, rates are set "according to the actual present value of
12 the assets employed in the public service." *Duquesne Light Co. v. Barasch*, 488 U.S. 299,
13 308 (1989).

14 [I]n determining present value [of a utility's assets],
15 consideration must be given to prices and wages prevailing at
16 the time of the investigation; and, in the light of all the
17 circumstances, there must be an honest and intelligent
18 forecast as to the probable price and wage levels during a
19 reasonable period in the immediate future. . . . It must be
 determined whether the rates complained of are yielding and
 will yield . . . a reasonable rate of return on the value of the
 property at the time of the investigation and for a reasonable
 time in the immediate future.

20 *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 408-09 (1926). *See also Simms v.*
21 *Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (1956). If the
22 evidence supporting the use of the Company's RCRB as its fair value rate base is
23 disregarded or if the Company's revenue requirement is based on the historic or book cost
24 of the Company's utility plant and assets (i.e., the OCRB) by adjusting the rate of return
25 on fair value to produce the same revenue requirement as Staff and RUCO advocate, the
26 Commission will violate Arizona law.

1 A. **The Evidence in This Case Does Not Support Averaging the Company's**
2 **RCRB and OCRB to Determine Its Fair Value Rate Base.**

3 Staff argues that the Commission should determine Arizona-American's fair value
4 rate base for each water and wastewater district by averaging the district's RCRB and its
5 OCRB. Staff's Br. at 2-3. However, Staff has provided no reason for doing so in this
6 case other than it has done so in the past. *Id.* For example, Staff's lead accounting
7 witness, Mr. Carlson, testified that "[t]his particular method is the one that this
8 Commission has used most." Carlson Sb. (Ex. S-48) at 6. Mr. Carlson also claimed that
9 the "Commission has determined this method to be reasonable and appropriate" (*id.*), but
10 neither Mr. Carlson nor any other Staff witness has identified any Commission rule or
11 decision containing such a determination.² As explained above and in the Company's
12 initial brief, it is well established that under the fair value standard, the *present value* of
13 the utility's plant and property must be determined and used as its fair value rate base in
14 setting rates. The evidence before the Commission shows that the best measure of the
15 present value of the Company's utility plant and property is its RCRB.

16 1. **The Commission Does Not Have Discretion to Violate the Law**
17 **and Ignore the Evidence.**

18 Staff argues that the Commission "has a range of legislative discretion" and must
19 "use reasonable judgment considering all relevant factors" in finding fair value. Staff Br.
20 at 2, *citing Simms*, 80 Ariz. at 154, 294 P.2d at 384. The existence of such discretion,
21 however, does not allow the Commission to ignore the law or the evidence. As the
22 Arizona Court of Appeals has explained:

23 [A rate proceeding] carries with it fundamental procedural
24 requirements. There must be a full hearing. There must be

25 ² In contrast, for example, the previous Commission decisions introduced by Staff during
26 the hearing contain no discussion of the basis for this approach, and no "determination"
 that it is "reasonable and appropriate." Ex. S-2 at 21; Ex. S-4 at 4; Ex. S-5 at 10. In fact,
 in each of those decisions, the weighting of RCRB and OCRB was not in dispute. *Id.*

1 evidence adequate to support pertinent and necessary findings
2 of fact. Nothing can be treated as evidence which is not
3 introduced as such. . . . Facts and circumstances which ought
4 to be considered must not be excluded. Facts and
5 circumstances must not be considered which should not
6 legally influence the conclusion. Findings based on the
7 evidence must embrace the basic facts which are needed to
8 sustain the order. . . .

9 A proceeding of this sort requiring the taking and weighing of
10 evidence, determinations of fact based upon the consideration
11 of the evidence, and the making of an order supported by
12 such findings, has a quality resembling that of a judicial
13 proceeding. Hence it is frequently described as a proceeding
14 of a *quasi-judicial* character. The requirement of a "full
15 hearing" has obvious reference to the tradition of judicial
16 proceedings in which evidence is received and weighed by
17 the trier of the facts. The "hearing" is designed to afford the
18 safeguard that the one who decides shall be bound in good
19 conscientious to consider the evidence, to be guided by that
20 alone, and to reach his conclusion uninfluenced by extraneous
21 considerations which in other fields might have play in
22 determining purely executive action. The "hearing" is the
23 hearing of evidence and argument.

24 *State ex rel. Corbin v. Arizona Corp. Comm'n*, 143 Ariz. 219, 224, 693 P.2d 362, 367
25 (1984) (italics in original), *quoting Morgan v. United States*, 298 U.S. 468, 480-81 (1936).

26 In this case, neither Staff nor any other party has provided any legitimate basis for using
the average of RCRB and OCRB as the Company's fair value rate bases in the face of
evidence showing that the current value of the Company's property exceeds RCRB.

**2. The Company's RCN Rate Bases Have Not Been Challenged and
Are Not in Dispute.**

Staff argues that the Commission should not give "great weight" to the RCRB
developed for each of the Company's water and wastewater districts because those rate
bases are not exactly equal to the current value of the utility plant and assets devoted to
public service. Staff Br. at 2-3. This argument ignores the evidence and distorts the
Company's position.

First, as discussed in the Company's initial brief, the Company's reproduction cost

1 new (RCN) plant-in-service study, as revised, and the resulting RCRB for each district
2 have been accepted by Staff. Scott Sb. (Ex. S-39) at 3-4; Bourassa Rj. (Ex. A-24) at 3, 7-
3 8. Mr. Stout, the Company's engineering valuation expert, evaluated the RCN studies
4 performed by both the Company and by Staff, and testified that RCN studies of this nature
5 have been used for many years by valuation experts to obtain an estimate of current value
6 and that the RCN studies "provide a reasonable basis for providing a fair value rate base
7 for each district." Stout Rb. (Ex. A-51) at 4-7. Mr. Stout's opinion, which is based on
8 some 30 years of experience as a valuation engineer (*id.* at 2-4), has not been contested by
9 any party. In short, Staff had ample opportunity to evaluate and, if appropriate, contest
10 the RCB for each district. Staff also had the opportunity to perform and submit its own
11 valuation studies. Instead, Staff has accepted the Company's RCN studies and the
12 resulting rate bases.

13 Second, the Staff's argument inaccurately suggests that the Company maintains
14 that the current value of its property is equal to the RCRB. This misstates the Company's
15 testimony. Under the fair value standard, rates are based on the present or current value of
16 the utility's assets devoted to public service. *E.g., Duquesne Light*, 488 U.S. at 308-09;
17 *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679,
18 689-92 (1923). The Company has consistently maintained that under the circumstances in
19 this case, the RCRB for each district provides the best estimate of the current value of the
20 district's utility plant and property. *E.g., Bourassa Dt.* (Ex. A-1) at 14-15; *Zepp Dt.* (Ex.
21 A-44) at 8-9; *Bourassa Rb.* (Ex. A-21) at 9-10; *Tr.* at 168-69. In contrast, Staff has
22 provided no evidence that the historic cost of the Company's utility plant provides an
23 accurate measure of fair value, nor has Staff shown why the Company's RCRB for each
24 district is inaccurate or otherwise overstates the fair value of its property. Averaging the
25 RCRB and the OCRB in the absence of any legitimate reason to do so would be arbitrary
26 and unsupported by the record.

1 3. **The Amount Recently Paid for the Acquisition of Citizens' Water**
2 **and Wastewater Systems Supports Use of the RCRB for Each**
3 **District.**

4 Staff also argues that the recent purchase price paid by Arizona-American in
5 acquiring Citizens' water and wastewater systems is not relevant to the determination of
6 fair value. In support of this argument, Staff misstates the holding of the Arizona
7 Supreme Court in *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d
8 412 (1959). In that case, the utility had purchased a group of water systems and, shortly
9 thereafter, applied for a determination of the fair value of the systems serving four
10 communities and for appropriate rate adjustments. *Id.*, 85 Ariz. at 200-01, 335 P.2d at
11 413. During the hearing, the utility and Staff presented various evidence of the value of
12 the utility's properties, including their cost of reproduction new and original cost less
13 depreciation. *Id.* However, the Commission ignored this evidence and instead relied
14 solely on the purchase price paid for the water systems, arguing "that a recent purchase
15 price is market value and that market value would be a fair value *as a matter of law.*" *Id.*
16 at 202-03, 335 P.2d at 415 (emphasis added). The court rejected that argument, holding
17 that "the purchase price of a public utility does not constitute, *as a matter of law*, its fair
18 value." *Id.* at 203, 335 P.2d at 415 (emphasis added).

19 In issuing this holding, the court did not state, as Staff erroneously represents, that
20 the purchase price paid by an acquiring company "should play no role in establishing rate
21 base." Staff Br. at 3. Instead, the court stated that "the Commission must consider all
22 available evidence related to the fair value, and an inquiry into a recent purchase
23 transaction might be of assistance" *Arizona Water*, 85 Ariz. at 203, 335 P.2d at 415.
24 In *Arizona Water*, the Commission ignored evidence indicating that the seller was willing
25 to accept an amount substantially less than the book value of the water systems "because
26 the transaction would give it a tax savings of one and one-half million dollars, a power
 contract worth a million dollars, as well as hundreds of thousands of dollars in interest."

1 *Id.* at 203, 335 P.2d at 415. The court concluded:

2 Thus, if the Commission had taken into consideration the
3 entire recent purchase transaction it would not have been an
4 abuse of discretion. But here the Commission considered
5 only that part of the transaction concerning the amount paid
6 to the seller, and in that respect it acted arbitrarily, as all
7 relevant factors were thus not considered in finding the fair
8 value of the properties.

9 *Id.* at 204, 335 P.2d at 415-16.

10 In this proceeding, in contrast, there are no unique or unusual circumstances
11 affecting the purchase price paid by Arizona-American for Citizens' water and wastewater
12 systems. Mr. Stephenson, who was personally involved in the transaction (*e.g.*, Tr. at 470,
13 477), testified that the purchase price was determined by arms-length negotiations
14 between two independent and sophisticated utilities. Stephenson Dt. (Ex. A-64) at 8-10.
15 *See also* Tr. at 486. Mr. Stephenson's testimony was not contested by any party.
16 Moreover, the Commission had an opportunity to thoroughly review and investigate the
17 transaction in connection, first by approving the sale and transfer of Citizens' assets to
18 Arizona-American pursuant to A.R.S. § 40-285 and, second, by authorizing Arizona-
19 American to issue new debt and to assume certain industrial development revenue bonds
20 in connection with financing the acquisition. Decision No. 63584 (April 24, 2001)
21 (authorization to transfer assets) and Decision No. 64002 (Aug. 30, 2001) (acquisition
22 financing). There is no evidence that the purchase price paid for Citizens' assets was
23 influenced by income tax considerations or any other factor that would preclude
24 consideration of the purchase price as evidence of fair value.

25 The other arguments found on page 3 of Staff's brief are simply irrelevant to the
26 issue. For example, the fact that Mr. Bourassa had not previously recommended the use
27 of an RCRB as a utility's fair value rate base has nothing to do with whether, under the
28 facts and circumstances present in this proceeding, the Company's recommendation
29 should be adopted. Mr. Bourassa explained, "I feel more comfortable with the company's

1 RCN rate base as being its fair value given the recent purchase of the Citizens systems by
2 Arizona-American, which is also an indicator of value.” Tr. at 168-69. Similarly, the fact
3 that Mr. Stephenson personally disagreed with the use of an average of the RCND and the
4 OCRB in prior rate proceedings for the Paradise Valley water district (then known as
5 Paradise Valley Water Company) is irrelevant to the issue of the appropriate method to be
6 used in determining the current value of Arizona-American’s utility plant and assets in
7 this case. Mr. Stephenson explained that the Paradise Valley water district was very
8 small, and, at that time, it was not worth pursuing a different weighting to determine that
9 district’s fair value rate base. Tr. at 489-92 and 513-15.³

10 **B. The “Acquisition Adjustment” Is a Red Herring.**

11 In its initial brief, the Company has explained why the acquisition adjustment that
12 has been recorded on the Company’s books in accordance with the Uniform System of
13 Accounts is irrelevant to the development of a fair value rate base. Company Br. at 24-26.
14 Both RUCO and Youngtown, however, continue to focus on the acquisition adjustment.

15 RUCO devotes several pages in its brief to a discussion of why the Company’s
16 OCRB for each district is overstated because it includes an acquisition adjustment.
17 RUCO Br. at 4-6. Given that the Company has repeatedly stated that it is not seeking
18 recovery on, or of, an acquisition adjustment in this proceeding, it is unclear why this
19 discussion has been included. *E.g.*, Stephenson Rb. (Ex. A-74) at 11 (“we have requested
20 a revenue requirement based on FVRB [fair value rate base], **excluding** the acquisition
21 adjustment”; emphasis in original). RUCO claims that the Company has argued that the
22 OCRB is greater than the RCRB for certain of its districts. RUCO Br. at 4-5. However,
23 the Company has made no such claim. This confusion appears to have arisen from a line
24 of questioning by RUCO’s attorney during the hearing concerning the Company’s B-1

25 ³ For example, during the test year used in setting rates in Decision No. 60220 (May 27,
26 1997), the Company provided water service to approximately 4,400 customers. Ex. S-6 at 1.

1 Schedule for the Agua Fria water district, during which Mr. Bourassa repeatedly
2 explained why it is inappropriate to include an acquisition adjustment in an RCRB. Tr. at
3 131-40. Ultimately, none of this discussion is relevant to the issues before the
4 Commission.

5 Youngtown is improperly attempting to use the acquisition adjustment as an excuse
6 to disregard the Company's RCRB for the Sun City water and wastewater districts.⁴
7 Preliminarily, it should be noted that Youngtown has no disagreement with the
8 Company's proposed accounting treatment concerning the acquisition adjustment. Tr. at
9 122-25. The Youngtown accounting witness, Mr. Burnham, has agreed that the Company
10 is required to record an acquisition adjustment for accounting purposes, and has no
11 disagreement with the Company's request to use 40-year mortgage-style amortization, as
12 opposed to straight-line amortization. Tr. at 1222-23. At the same time, however,
13 Youngtown contends that the Commission should give no weight to the RCRB in
14 establishing their fair value rate bases because "anything greater than OCRB" would
15 *implicitly* include an acquisition adjustment. Tr. at 1251-52; Youngtown Br. at 10-11.
16 This argument is erroneous for at least two reasons.

17 First, there is no acquisition adjustment, or any other type of similar adjustment,
18 included in the Company's calculation of the RCRB for each district. The methodology
19 used by the Company, which Staff has accepted, is discussed at length in the Company's
20 initial brief. Company Br. at 17-20. In summary, Mr. Bourassa prepared a trended RCN
21 plant-in-service study to determine the cost of reproducing the utility plant and property
22 devoted to public service for each district. From that starting point, Mr. Bourassa then
23 trended and restated accumulated depreciation, advances in aid of construction and
24 contributions in aid of construction, which were then deducted from the RCRB, in

25
26 ⁴ Youngtown has intervened only in connection with, and is presenting recommendations
relevant to, those particular districts. Tr. at 1214.

1 accordance with applicable Commission rules. Ultimately, the RCRB for each district, as
2 revised, was accepted by Staff, and neither Youngtown nor any other witness has objected
3 to those amounts. As shown on the Company's schedules, there is simply no adjustment
4 to any of these rate bases reflecting an acquisition adjustment. See Bourassa Rj. (Ex. A-
5 24), Rejoinder Schedules B-1 (rate base summary) and B-3 (adjustments to RCRB). See
6 also Tr. at 105 ("The [RCRB] does not include an acquisition adjustment It is the
7 company's estimate of the current value of its utility property.") and 123 (same).

8 Second, because no acquisition adjustment or other, similar sort of adjustment was
9 included in the RCRB, Youngtown's recommendation would be punitive and
10 discriminatory. This point was demonstrated by the hypothetical posed to Mr. Burton
11 during the hearing, in which Mr. Burton was asked whether it would have been
12 permissible for Citizens to have submitted RCN studies and to have requested a return on
13 an RCRB for the districts, assuming that no sale had occurred. Mr. Burton agreed that
14 Citizens would have had the right to do so. Tr. at 1279-81. Clearly, it would be
15 inappropriate to prohibit Arizona-American from seeking a return on an RCRB for each
16 district simply because the RCRB happens to be greater than the OCRB, when the prior
17 owner of the districts, Citizens, would have the right to request the identical rate-making
18 methodology. Indeed, if Youngtown's argument were carried to its logical conclusion,
19 every Arizona utility *except* Arizona-American would be allowed to file for and request
20 the use of an RCRB as its fair value rate base.

21 In short, the goal of fair value rate-making is to determine the current value of the
22 utility's property, which is then used as the utility's rate base. *E.g., Duquesne Power*, 488
23 U.S. at 308; *US West*, 201 Ariz. 245-56, ¶¶ 13-18, 34 P.3d 354-55.

24 It is impossible to ascertain what will amount to a fair return
25 upon properties devoted to public service, without giving
26 consideration to the cost of labor, supplies, etc., at the time
the investigation is made. An honest and intelligent forecast
of probable future values, made upon a view of all the

1 relevant circumstances, is essential. If the highly important
2 element of present costs is wholly disregarded, such a
3 forecast becomes impossible. Estimates for to-morrow
4 cannot ignore prices of to-day.

5 *State of Mo. ex rel. Southwestern Bell Telephone Co. v. Pub. Serv. Comm'n*, 262 U.S. 276,
6 287-88 (1923). Book accounting adjustments based on historic costs are irrelevant to this
7 determination, as Mr. Bourassa and Mr. Stephenson have both explained. For this reason,
8 the arguments presented by RUCO and Youngtown are irrelevant.

9 **C. The "Backing In" Methodology Advocated by Staff and RUCO Violates**
10 **the Fair Value Standard.**

11 **1. Under Arizona Law, the Commission Must Find and Use Fair**
12 **Value to Set Rates.**

13 In their briefs, both Staff and RUCO continue to advocate the use of the so-called
14 "backing in" method, under which the utility's revenue requirement is always based on its
15 OCRB. Staff Br. at 4-6; RUCO Br. at 3-4. As the Company explained in its initial brief,
16 under Arizona law, the fair value of the utility's property is the utility's rate base, and the
17 rate of return must be applied to that rate base in order to establish just and reasonable
18 rates. Company Br. at 13-16, 54-55. To ensure that there is no confusion on this key
19 point, and to respond to Staff's discussion about the Arizona Supreme Court's holding in
20 *US West*, a brief review of Arizona appellate decisions is necessary.

21 The seminal Arizona decision is, of course, *Simms*, in which the Arizona Supreme
22 Court held, based on Article 15, § 14 of the Arizona Constitution, that the Commission
23 must find the fair value of the utility's property and use that finding as the utility's rate
24 base in setting rates:

25 It is clear, therefore, that under our constitution as interpreted
26 by this court, the commission is required to find the fair value
of the company's property *and use such finding as a rate base*
for the purpose of calculating what are just and reasonable
rates.

Simms, 80 Ariz. at 151, 294 P.2d at 382 (emphasis added), following *State v. Tucson Gas*,

1 *Electric Light & Power Co.*, 15 Ariz. 294, 303, 138 P. 781, 785 (1914), and *Ethington v.*
2 *Wright*, 66 Ariz. 382, 391-93, 189 P.2d 209, 215-16 (1948).

3 *Simms* was followed by the Arizona Supreme Court three years later in *Arizona*
4 *Water*, discussed above, in which the court stated:

5 This court has held that under our constitution the
6 Corporation Commission must find the fair value of the
7 properties devoted to the public use, and that in determining
8 the fair value the Commission cannot be guided by the
9 prudent investment theory nor can it use common equity as
10 the rate base standard. . . . The amount of capital invested is
immaterial. *Under the law of fair value a utility is not*
entitled to a fair return on its investment; it is entitled to a
fair return on the fair value of its properties devoted to the
public use, no more and no less.

11 *Arizona Water*, 85 Ariz. at 203, 335 P.2d at 415 (emphasis added), *citing and following*
12 *Simms*.

13 These two decisions provide the framework for fair value rate-making in Arizona,
14 and have been consistently followed by Arizona appellate courts. *E.g.*, *Arizona Corp.*
15 *Comm'n v. Arizona Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976);
16 *Residential Utility Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 561, ¶ 11,
17 20 P.3d 1169, 1172 (App. 2001); *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34,
18 578 P.2d 612, 614-15 (App. 1978). Far from overruling this line of decisions, the Arizona
19 Supreme Court in *US West* affirmed these decisions *in a monopoly setting*:

20 As we have seen, a line of cases nearly as old as the state
21 itself has sustained the traditional formulaic approach. . . .

22 We still believe that when a monopoly exists, the rate-of-
23 return method is proper. . . . We agree that our previous cases
establishing fair value as the exclusive rate base are
inappropriate for application in a competitive environment.

24 *US West*, 201 Ariz. 242, 246, ¶¶ 18-19, 34 P.3d at 355 (emphasis added).

25 The Arizona Supreme Court's discussion of fair value rate-making was specifically
26 noted by the Arizona Court of Appeals in a decision issued on January 27, 2004. *Phelps*

1 *Dodge Corp. v. Arizona Electric Power Coop., Inc.*, ____ Ariz. ____, ____ P.3d ____,
2 2004 WL 117253 (App. 2004). There the court stated:

3 In monopolistic markets, "*fair value has been the factor by*
4 *which a reasonable rate of return was multiplied to yield,*
5 *with the addition of operating expenses, the total revenue that*
6 *a corporation could earn.*" . . . Although *US West II* held
7 that this rate-of-return method for rate setting may be
inappropriate in a competitive environment, it affirmed the
supreme court's long-standing view that this method is
properly employed in traditional, non-competitive markets.

8 *Phelps Dodge*, 2004 WL 117253 at *5, ¶ 21 n. 8 (emphasis added), *quoting US West*, 201
9 Ariz. at 245, ¶ 13, 34 P.3d at 354. There can be no legitimate dispute about what the law
10 requires.

11 Viewed against this 90-year-old legal framework, it is apparent that the rate setting
12 methodology advocated by Staff and RUCO in this case is illegal. Contrary to the
13 disingenuous arguments appearing on pages 4 and 5 of Staff's brief, the Commission does
14 not have "wide latitude" to ignore settled law and base Arizona-American's revenue
15 requirement solely on the OCRB for each water and wastewater district. Arizona courts
16 (as well as numerous U.S. Supreme Court decisions that address the fair value standard)
17 have held that the Commission must find *and use* the fair value of the utility's property to
18 set rates.

19 Under the "backing in" method advocated by Staff and RUCO, in contrast, a
20 finding of fair value is unnecessary and meaningless. For example, if a utility's OCRB is
21 \$1 million, it makes no difference whether the fair value of the utility's property is
22 \$500,000 or \$1.5 million – the revenue requirement does not change. *E.g.*, *Diaz Cortez*
23 *Sb. (Ex. R-8)* at 3-4 (explaining that regardless of the amount of the fair value rate base,
24 "*the revenue requirement remains constant*"; italics in original); *Carlson Dt. (Ex. S-47)* at
25 8 ("Operating income should be calculated by applying the recommended cost of capital
26 to the OCLD rate base. Revenue requirement is equal to the sum of operating income,

1 operating and maintenance expenses, depreciation expense, and income tax expense.”).
2 This makes a mockery out of the fair value standard, as at least two Arizona courts have
3 recognized. *Simms*, 80 Ariz. at 155, 294 P.2d at 385; *Arizona Corp. Comm’n v. Citizens*
4 *Utilities Co.*, 120 Ariz. 184, 190 n. 5, 584 P.2d 1175, 1181 n. 5.⁵

5 **2. The Fair Value Method Does Not “Double Count” Inflation.**

6 RUCO’s principal argument in support of using Arizona-American’s OCRB to
7 determine the revenue requirement is that the application of a rate of return to the fair
8 value rate base “factors inflation in twice, thereby overstating the Company’s proposed
9 revenue requirement.” RUCO Br. at 4. This argument has no legal foundation.

10 For example, in *Simms*, the court discussed the application of a 7.01% rate of
11 return to the utility’s fair value rate base, while noting that if the Commission had adjusted
12 the rate of return to produce a pre-determined revenue requirement, the Commission
13 would be acting illegally. 80 Ariz. at 155, 294 P.2d at 385. Similarly, in *Southwestern*
14 *Bell*, the U.S. Supreme Court discussed the application of a rate of return of 5.33% to the
15 utility’s fair value rate base, which return the court found “wholly inadequate, considering
16 the character of the investment and interest rates then prevailing.” *Southwestern Bell*, 262
17 U.S. at 288. In *Bluefield Waterworks*, which is still cited today as establishing the
18 standard for setting a utility’s rate of return, the court again applied the rate of return
19 directly to the utility’s fair value rate base, holding that “a rate of return of 6 [%] upon the
20 value of the property is substantially too low to constitute just compensation for the use of
21 the property employed to render the service.” *Bluefield Waterworks*, 262 U.S. at 695. See

22
23 ⁵ In its brief, Staff claims that the “backing in” method was approved in *Litchfield Park*
24 *Serv. Co. v. Arizona Corp. Comm’n*, 178 Ariz. 431, 874 P.2d 998 (App. 1994). However,
25 Staff has also misstated this decision’s holding. In fact, the utility did *not* challenge the
26 use of the “backing in” method to derive the rate of return on its fair value rate base.
Instead, the utility challenged an adjustment to the amount of equity in its capital
structure, the authorized return on equity and the exclusion of a well from rate base. *Id.*
Consequently, it is not surprising that this decision was not mentioned by the Arizona
Supreme Court in *US West* or by the Arizona Court of Appeals in *Phelps Dodge*.

1 also *id.* at 693-94 (discussing various decisions approving returns of 6% to 8% on fair
2 value rate bases). In none of the decisions did the court suggest that applying the rate of
3 return "double counts" inflation, or that some sort of inflation-related adjustment was
4 required.

5 Putting aside the lack of any legal support for RUCO's views, RUCO has ignored
6 the fact that the "fair value standard mimics the operation of the competitive market."
7 *Duquesne Light*, 488 U.S. at 308. In a competitive market, as the value of property
8 increases, so does the rent associated with the use of that property. The fair value
9 standard operates the same way:

10 To the extent utilities' investments in plant are good ones
11 (because their benefits exceed their cost) they are rewarded
12 with an opportunity to earn an "above-cost" return, that is, a
13 fair return on the current "market value" of the plant. To the
14 extent utilities' investments turn out to be bad ones (such as
plants that are cancelled and so never used and useful to the
public) utilities suffer because the investments have no fair
value and so justify no return.

15 *Id.*, 488 U.S. at 308-09. Under RUCO's argument, however, these changes in value are
16 completely irrelevant to the rate setting process because the utility's revenue requirement
17 is always based solely on OCRB.

18 In addition, Dr. Zepp explained why RUCO's argument concerning the effect of
19 inflation is misplaced:

20 Whatever inflation factors are in the cost of capital, they are
21 investor forecasts of the future – not the past. Moreover,
22 those inflation factors in the cost of capital are not plant
23 specific, but would reflect the more general level of inflation
24 in the economy expected in the future. The fallacy in Ms.
25 Diaz Cortez's analysis is seen most clearly by examining a
26 situation in which the value of the plant at the time of inquiry
is lower than original cost. In such a case, there would be
negative inflation (deflation) used to determine the FVRB
[fair value rate base], but the cost of capital would still reflect
the opportunity cost of capital and include positive inflation,
if that's what investors anticipate.

1 Zepp Rb. (Ex. A-49) at 32. *See also* Tr. at 315-17; Zepp Rj. (Ex. A-50) at 8. RUCO has
2 never explained how the use of the Company's embedded debt cost, which comprises
3 60% of the Company's total capital, in determining the Company's rate of return factors
4 in inflation. Nor has RUCO explained how the "backing in" method actually adjusts the
5 rate of return for inflation. Finally, RUCO does not consider other factors affecting the
6 present value of a utility's property, such as legal and regulatory requirements that
7 increase the cost of construction. In short, RUCO's argument is simplistic and
8 misleading.

9 **3. Staff's Policy Arguments in Support of the "Backing In" Method**
10 **Conflict with the Fair Value Standard.**

11 Staff's attacks on Dr. Zepp's so-called "legal conclusions" are largely irrelevant to
12 the issues presented. As Staff notes on the top of page 5 of its brief, Dr. Zepp has
13 consistently stated that he is an economist with extensive experience in ratemaking and
14 other types of proceedings involving utilities, and not an attorney. *E.g.*, Zepp Rb. (Ex. A-
15 44) at 12. Further, Arizona-American does not rely on Dr. Zepp's analysis of relevant
16 court decisions such as *Simms*, *US West* and *Bluefield Waterworks*. Those decisions, and
17 the other authorities that have been discussed in the Company's initial brief and
18 hereinabove addressing the fair value standard, obviously speak for themselves.
19 However, Staff has ignored the most important point made by Dr. Zepp: The
20 determination of a utility's rate base and the determination of the rate of return to be
21 applied to that rate base are separate and independent determinations. *E.g.*, Zepp Dt. (Ex.
22 A-44) at 9-10; Zepp Rb. (Ex. A-49) at 33; Tr. at 309, 316. For example, Dr. Zepp
23 explained:

24 My equity cost estimates are independent of the rate base to
25 which they are applied. The equity cost estimates I present
26 are determined from market data and provide an estimate of
the equity return an investor requires on dollars invested in
shares of common stock. Actual equity returns depend, in

1 part, on the rate base that is incorporated into the process that
2 sets rates. Those stock prices also depend in part on the
3 present value of cash or securities that an investor expects to
4 be received if the utility were condemned by a public agency,
5 acquired by a municipality or another utility, or merged into
6 another utility. Thus, the percentage equity cost estimates are
7 independent of whatever formula is used to determine the
8 FVRB [fair value rate base].

9 Zepp Dt. (Ex. A-44) at 9-10.

10 As explained in the Company's initial brief, all of the parties' cost of capital
11 witnesses used versions of standard finance models – the Discounted Cash Flow (“DCF”)
12 model, the Risk Premium method and the Capital Asset Pricing Model (“CAPM”) – to
13 estimate the current cost of equity. Each of these methodologies relies on stock market
14 data for publicly traded firms, and has nothing to do with the rate base used to set rates.
15 For example, Mr. Reiker testified that “[t]he DCF method of estimating the cost of equity
16 is based upon the theory that the market price of a stock is equal to the present value of all
17 expected future dividends.” Reiker Dt. (Ex. S-45) at 9. *See also* Staff Br. at 15 (same).
18 Similarly, Mr. Reiker describes the CAPM as presenting “a simple and intuitively
19 appealing picture of financial markets,” in which “[a]ll investors hold efficient portfolios
20 [of stock] and all such portfolios move in perfect lock step with the market.” Reiker Dt.
21 (Ex. S-45) at 21, *quoting* James Lorie and Mary T. Hamilton, *The Stock Market: Theories*
22 *and Evidence* 202 (1973). *See also* Staff Br. at 17. Mr. Reiker also explained that “Staff
23 did not apply the models directly to Arizona-American because it does not have publicly
24 traded stock and therefore lacks information necessary to apply the market-based models.”
25 Reiker Dt. (Ex. S-45) at 9. For this reason, Mr. Reiker (as well as Dr. Zepp and Mr.
26 Rigsby) used publicly traded water and gas distribution utilities as proxies. In sum, all of
the methodologies employed by the parties are completely independent of the rate bases
of Arizona-American as well as the publicly traded utilities in each parties' proxy group.⁶

⁶ The other component of the cost of capital, the cost of long-term debt, is also

1 Staff claims in its brief that Mr. Reiker has provided "economic reasons" for
2 applying the weighted average cost of capital to the OCRB, i.e., for using the "backing in"
3 method. Staff Br. at 6. However, these "economic reasons" are simply a restatement of
4 the prudent investment theory originally suggested by Justice Brandeis in *Southwestern*
5 *Bell*. See *Duquesne Light*, 488 U.S. at 309. The prudent investment method "relies on the
6 actual historical cost of investments as the basis for setting the rate," as opposed to the
7 current or fair value of the utility's plant. *Id.* at 309 n. 6. The argument presented by Mr.
8 Reiker on pages 63 through 66 of his Direct Testimony, referenced in Staff's brief, are
9 predicated on the prudent investment theory. For example, Mr. Reiker has testified:

10 Q. When would a utility expect to be able to earn the cost
11 of capital *on its investment* if earnings were
12 determined by multiplying the market-based ROR by
the RCNRB?

13 A. A utility would expect to be able to earn the cost of
14 capital *on its investment* if earnings were determined
15 by multiplying the ROR by the RCNRB only when the
16 RCNRB is equal to the OCRB. Windfall gains
(losses) would result whenever the RCNRB is greater
(less) than the OCRB if the Commission multiplied
the ROR by the RCNRB to determine earnings.

17 Reiker Dt. (Ex. S-45) at 64 (emphasis added).

18 Under Mr. Reiker's reasoning, as shown above, the critical inquiry is the utility's
19 investment, not the fair value of the utility's property. Consequently, his argument is in
20 direct conflict with the various decisions discussed above, in which the prudent
21 investment approach was squarely rejected. For example, in *Arizona Water* the Arizona
22 Supreme Court stated: "The amount of capital invested is immaterial. Under the law of
23 fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair
24

25 independent of the determination of rate base. That cost is simply the average cost of all
26 outstanding long-term debt instruments, as illustrated in Mr. Reiker's testimony. Reiker
Sb. (Ex. S-46), Schedule JMR-S17. See also Staff Br. at 14.

1 return on the fair value of its properties devoted to the public use, no more and no less.”
2 *Arizona Water*, 85 Ariz. at 203, 335 P.2d at 415. There is no “windfall” gain or loss under
3 the fair value standard because the utility’s earnings are dependent on the fair value of its
4 property devoted to public service, and not on its level of investment. *E.g., Duquesne*
5 *Light*, 488 U.S. at 308-09.

6 Moreover, the “economic” argument presented by Mr. Reiker is in conflict with
7 Staff’s own rate setting methodology. Mr. Reiker’s recommended rate of return, 6.5%, is
8 not applied to Arizona-American’s investment in the 10 water and wastewater districts
9 involved in this proceeding. Instead, Staff’s rate of return is applied to each district’s
10 OCRB. Arizona-American’s total investment in these districts’ utility plant and property
11 is approximately \$270 million. Stephenson Supp. Dt. (Ex. A-69 – Ex. A-73) at 1-2 and
12 Tab A.⁷ In contrast, the OCRB for each of the 10 districts proposed by Staff total
13 approximately \$92 million. Bourassa Rj. (Ex. A-24) at Rejoinder Schedule 2. Thus,
14 Staff’s rate bases have nothing to do with Arizona-American’s investment. Likewise, the
15 combined operating income produced by Staff’s recommendations for each of the districts
16 is approximately \$6 million while the Company’s annual debt service cost, as computed
17 by Mr. Reiker, exceeds \$8 million. Stephenson Rb. (Ex. A-74), Rebuttal Exhibit 4;
18 Reiker Sb. (Ex. S-46), Schedule JMR-S17. Thus, Staff’s recommendations have nothing
19 to do with Arizona-American’s actual cost of capital.

20 Another example of the fallacy in Staff’s argument is found in cost of capital
21 testimony recently filed by Mr. Reiker in the pending rate application filed by Arizona
22 Public Service Company (“APS”). In that proceeding, Mr. Reiker is recommending that
23 the utility’s capital structure include \$500 million in long-term debt incurred by APS in
24 providing financing to Pinnacle West Energy Corporation (“PWEC”), an affiliated entity.

25 ⁷ This amount is based on the debt and equity used to finance the acquisition of Citizens’
26 water and wastewater systems excluding the Mohave wastewater district (formerly known
as Sorenson Utility Company).

1 At the same time, Staff is recommending that the power generation assets financed by this
2 long-term debt be excluded from rate base. Mr. Reiker has testified that the \$500 million
3 of long-term debt must be included in the utility's capital structure and used to compute
4 its rate of return, regardless of whether the PWEC generation assets are included in rate
5 base, explaining that "[i]nvestors do not ignore debt, nor do they color-code it." Direct
6 Testimony of Joel M. Reiker at 3-4, Docket No. E-01345A-03-0437 (filed Feb. 3, 2004).
7 The rate of return is reduced by including the \$500 million of low-cost debt in APS's
8 capital structure. At the same time, APS would not earn a return on this capital because
9 the plant this debt is financing is excluded from rate base. Once again, the utility's rate
10 base and its cost of capital are not related.

11 In short, there is no dispute that the utility's rate base and the rate of return are
12 determined independently, as Dr. Zepp has explained. The rate of return is determined
13 using stock market data for publicly traded firms and the utility's embedded debt cost.
14 The rate of return is then applied to the rate base, without regard to the size of the rate
15 base. It is irrelevant whether the resulting revenue requirement actually allows the utility
16 to earn the cost of capital on its investment.⁸ Putting aside the law, which clearly
17 prohibits the use of the prudent investment approach, Mr. Reiker's arguments directly
18 conflict with the methodology Staff actually employs.

19 **D. Staff's Level of Accumulated Depreciation is Punitive.**

20 Staff asserts that the Company attempted to "inflate" its revenue requirement by
21 including \$2 million in rate base that should not have been included. Staff Br. at 19. As a

22
23 ⁸ Thus, for example, Mr. Reiker also contends in this case that Staff's rate of return, as
24 applied to Arizona-American's OCRB for each district, produces a pre-tax interest
25 coverage of 3.0, when the Company's annual debt service payments, which total \$8.2
26 million, are approximately equal to Staff's recommended revenue requirement plus taxes.
See Reiker Sb. (Ex. S-46), Schedules JMR-S8 (showing capital structure and interest
coverage) and JMR-S17 (showing annual debt service). Arizona-American's actual cost
of capital is irrelevant because Staff's cost of capital and resulting rate of return are
independent of Staff's rate base.

1 result, and as a penalty, when Staff removed this plant it refused to remove an additional
2 \$438,000 of accumulated depreciation associated with these plant items.⁹ There is no
3 dispute that it is appropriate to adjust the plant balances because, as Staff correctly pointed
4 out, the approximately \$2 million of plant is either no longer used and useful or
5 unidentified. Tr. at 1160. Instead, the dispute centers on Staff's efforts to reap a windfall
6 for Arizona-American's ratepayers. Staff's arguments in support of its position are,
7 however, misleading and its recommendation is contrary to sound ratemaking principles.

8 First, the \$2 million is a "gross" plant number, so the effect on rate base would
9 have been smaller. Moreover, this is a very small number compared to total gross plant of
10 \$272 million. See Bourassa Rj. (Ex. A-24) at Bourassa Rejoinder Schedules B-1. As
11 Staff witness Bozzo conceded, mistakes are common in the process of auditing plant (Tr.
12 at 1189) and this mistake impacted less than .75% of the total gross plant on the
13 Company's books.

14 Additionally, this is not, as Staff erroneously suggests, a case of the Company not
15 accepting the effect of a disallowance. Staff Br. at 19. Again, the Company accepted the
16 removal of \$2 million of plant from its gross plant, but did not accept Staff's failure to
17 properly reflect the disallowance. As Mr. Bourassa explained in his Rejoinder Testimony,
18 it is proper to remove both the plant amount and the associated accumulated depreciation
19 when removing plant that is unidentified or no longer used and useful. Bourassa Rj. (Ex.
20 A-24) at 4-6. Staff recognized this, but simply refused to afford this treatment in this
21 case. Tr. at 1186.

22 Staff's argument that salvage value must first be calculated also fails to support
23 Staff's failure to follow the proper ratemaking treatment. Staff Br. at 19. The lack of a
24

25 ⁹ Staff did remove some of the accumulated depreciation when it removed plant from rate
26 base. Bozzo Dt. (Ex. S-43) at 5-8. However, the parties' dispute centers on whether an
additional \$438,000 worth of accumulated depreciation should have been removed. Tr. at
1162.

1 salvage value did not preclude Staff from removing the plant. Perhaps more importantly,
2 Mr. Jones made it clear that such plant effectively has no salvage value and Mr. Bozzo
3 accepted this testimony. Tr. at 1187.

4 In the end, therefore, Staff's argument that the Company should not be
5 "advantaged" by the removal of \$2 million of plant from rate base is nothing more than a
6 smoke screen for Staff's attempt to further disadvantage the Company by inflating the
7 effect of the disallowance, and thereby deflating the revenue requirement. In reality, Staff
8 is simply punishing Arizona-American by removing plant without removing all of the
9 accumulated depreciation related to that plant. The Commission should approve the
10 disallowance of \$2 million of plant and with it the removal of an additional \$438,000 of
11 accumulated depreciation, in accordance with sound ratemaking principles.

12 **III. INCOME STATEMENT ISSUES.**

13 **A. Staff's Opposition to the Pro Forma Adjustment to Operating Expenses**
14 **is Groundless and Should Be Rejected.**

15 Staff's opposition to the Company's proposed pro forma adjustments to remove
16 Citizens' overheads and salaries and wages and bring in AWW overheads, salaries and
17 wages and Service Company charges is rooted in the assertion that the Company is
18 attempting to "dodge the consequences of selecting 2001 as the test year." Staff Br. at 6.
19 In addition, Staff asserts that: (1) the 2002 figures for AWW overheads, salaries and
20 wages and Service Company charges are not known and measurable; (2) the use of the
21 2002 figure creates a mismatch; (3) the 2002 figures are imprudently high; and (4) the
22 proposed pro forma adjustments it makes ratepayers responsible for a new owners higher
23 cost. Staff Br. at 6-7. In its initial closing brief, the Company explained in detail, with
24 citation to the evidence in this docket, why the 2002 numbers for AWW overheads,
25 salaries and wages and Service Company charges were known and measurable and further
26 addressed Staff's argument that the proposed pro forma adjustments to operating expenses

1 did not create an improper mismatch. Company Br. at 31-33. As Staff offers no new
2 argument or evidence, there is no need to reiterate those arguments in this reply brief.
3 However, Staff's claims that the Company is seeking to avoid the impact of a 2001 test
4 year, that the 2002 figures are simply too high and should not be paid by ratepayers as
5 well as Staff's effort to separate out interrelated adjustments in order to more favorably
6 portray its position must be addressed herein. As explained below, none of these reasons
7 supports rejecting the proposed pro forma adjustment to operating expenses.

8 **1. Arizona-American Is Not Seeking to Evade the Effect of Using a**
9 **2001 Test Year.**

10 Implicit in Staff's argument is the notion that the Company should have waited
11 another year (or more) to file rate cases for the 10 water and wastewater systems.
12 However, as Mr. Stephenson testified, as a legal, accounting, financial and practical
13 matter, these cases had to be filed using a 2001 test year. Stephenson Rj. (Ex. A-75) at 8-
14 9. For example, the Company was required to file a rate case for the Anthem water and
15 Anthem wastewater systems. In addition, it had been several years since rate cases had
16 been filed, no less than 7, and with respect to the water systems in Mohave County, it had
17 been more than 10 years. *Id.* at 9. Further delays in filing would have made it even more
18 difficult to reconcile plant records since the last rate cases. Tr. at 1537-38. Finally, of
19 course, the Company's decision to file when it did was further justified when the
20 Commission instituted a three-year moratorium on rate increases because, as Mr.
21 Stephenson testified, the Company could not have survived financially without rate relief
22 until sometime in 2007. Stephenson Rj. (Ex. A-74) at 3.

23 Once the Company selected the 2001 test year for all of these reasons, it was
24 incumbent on the Company to assess the necessity for pro forma adjustments to test year
25 data. As Mr. Bourassa explained, Citizens' corporate overheads and salaries and wages
26 were non-recurring expenses. Tr. at 1544-45. Under proper rate-making, non-recurring

1 expenses are removed and expenses that are more characteristic of the Company's costs to
2 be incurred during the time the rates are in effect are brought in. Accordingly, the
3 Company's decision to propose a pro forma adjustment is not, as Staff continues to
4 suggest, an attempt to evade the impact of selecting a 2001 test year. It is the appropriate
5 rate making step once the Company was required to file using a 2001 test year.

6 **2. Staff's Attempts to Exaggerate the Rate Impact of the**
7 **Company's Pro Forma Adjustment are Misleading and Must be**
8 **Rejected.**

9 In order to exaggerate the impact of the Company's proposed pro forma
10 adjustments, Staff attempts to separate the adjustment to remove non-recurring Citizens'
11 overheads and replace them with AWW overheads and Service Company charges from
12 the interrelated adjustment to remove Citizens' salaries and wages and bring in Arizona-
13 American's salaries and wages. Staff Br. at 6-8; Tr. at 1044-47. As Mr. Bourassa
14 explained, however, the adjustment to remove Citizens' overheads is directly interrelated
15 to the adjustment to remove Citizens' salaries and wages. Tr. at 1545-50. The same is
16 true of the adjustments to bring in AWW overheads and Service Company charges and
17 Arizona-American's salaries and wages, which adjustments are directed related to the
18 removal of Citizens' test year data. *Id.* In sum, the Company proposed a series of
19 interrelated pro forma adjustments, accepted in concept by RUCO, i.e., to remove a
20 Citizens' "apple" and substitute Arizona-American's "apple" because the Arizona-
21 American "apple" reflects the Company's expenses on a going-forward basis. In contrast,
22 Staff seeks to portray the Company's adjustment as first removing the Citizens' "apple"
23 and then bringing in an Arizona-American "orange." This mischaracterizes the
24 Company's pro forma adjustment and should be rejected.

25 The same is true of Staff's erroneous claim that "Arizona-American's expenses are
26 \$3.6 million greater than the former owner's expenses. This level of expense is
imprudent, and it should be rejected." Staff Br. at 7. Again, as Mr. Bourassa explained,

1 when the Company's proposed pro forma adjustment to operating expenses is considered
2 as a whole, the net effect on the Company's ratepayers is an increase of expenses of \$1.5
3 million. Tr. at 1548-50. Moreover, this level of expense *is* prudent. As Mr. Jones and
4 Mr. Stephenson both explained, without the transition to incorporate AWW's
5 administrative and general corporate services, including the Service Company charges,
6 into the operation of these water and wastewater systems, adequate service to customers
7 would not have continued much beyond the test year. Tr. at 284, 1603-05; Jones Rj. (Ex.
8 A-35) at 7-8.

9 There is overwhelming evidence supporting the Company's testimony that
10 Citizens' 2001 overheads and salaries and wages were irregular. Citizens' test year
11 corporate overheads and salaries and wages were are artificially decreased due to the
12 pending sale of the water and wastewater systems. For example, Ray Jones, who was
13 Vice President of Citizens' Arizona water and wastewater operations prior to Arizona-
14 American's acquisition, testified that Citizens had taken numerous steps to reduce costs in
15 late 1999 and continuing in 2000, and that this cost-cutting reached its peak in 2001.
16 Jones Rj. (Ex. A-35) at 7-8. The evidence further shows that these cost-cutting measures
17 had a substantial impact on the level of Citizens' operating expenses in 2001. Ex. A-88.
18 In fact, Citizens' combined overheads and salaries and wages for 2001 were
19 approximately \$7.3 million *less* than the average of such costs for 1999 and 2000. *Id.*

20 Staff produces no evidence to contradict Mr. Jones' testimony, which is borne out
21 by Citizens' expense data for 1999, 2000 and 2001, clearly showing that Citizens' test
22 year operating expenses were irregular. Instead, Staff selectively ignores the portions of
23 Mr. Jones' testimony and the record that contradicts their position. What cannot be
24 ignored, however, is the fact that the Company's proposed pro forma adjustment results in
25 AWW overheads, Service Company charges and salaries and wages that are significantly
26 *lower* than the average of Citizens' 1999 and 2000 overheads and salaries and wages. Ex.

1 A-88. Thus, the Company's proposed pro forma adjustment results in an expense level
2 that is not "simply too high" and that reflects necessary expenses being incurred by the
3 Company to the benefit of ratepayers.

4 **B. Rate Case Expense.**

5 **1. RUCO's Lone Opposition to Rate Case Expense Should be**
6 **Rejected.**

7 In its brief, RUCO continues to argue that the Company's rate case expense should
8 be no more than \$418,941. RUCO Br. at 7. In support of this recommendation, RUCO
9 argues that the Company "failed to mitigate its rate case expense." *Id.* Each of RUCO's
10 reasons is without support in the record and should be rejected. From the outset, though,
11 it cannot be understated, the Company agrees that its rate case expense for this
12 proceeding, over \$1 million, is high. Tr. at 1594. The real question, as RUCO actually
13 frames it, is whether the Company is responsible for that level of rate case expense. The
14 simple answer to that question is no.

15 The Company is not responsible for, and has little control over, the process utilized
16 by this Commission for setting rates, which includes liberal and substantial discovery, five
17 rounds of pre-hearing filings, liberal intervention, lengthy evidentiary hearings, and
18 multiple rounds of post-hearing briefing, followed eventually by exceptions and the
19 appearances before the Commission at an Open Meeting. The bottom line is that
20 Commission rate case proceedings are complex and involve a substantial expenditure of
21 resources, with the applicant utility bearing the burden of proof and having to invest the
22 greatest amount of time and resources in prosecuting its application.

23 Nor has the Company employed a "misguided and unorthodox approach" creating
24 its own excessive rate case expense. RUCO Br. at 8. In fact, the sole factor RUCO offers
25 in support of this tiresome allegation is the selection of a 2001 test year, which required
26 review of Citizens' data. *Id.* Yet, the only issue in this case resulting from the use of

1 2001 test year was the dispute over the pro forma adjustment to remove Citizens' test year
2 overheads and salaries and wages and bring in AWW overheads, Service Company
3 charges and salaries and wages, an adjustment RUCO supports because the Citizens' data
4 is irrelevant to Arizona-American's operations. Tr. at 609; Moore Dt. (Ex. R-3) at 3.
5 Moreover, as discussed above, there were compelling reasons requiring the filing of this
6 case using a 2001 test year. Stephenson Rj. (Ex. A-75) at 8-9. Finally, RUCO simply
7 ignores clear and convincing evidence that delay would have exacerbated, not reduced,
8 rate case expense. Tr. at 1537-38.

9 RUCO's argument that that the Company spent an exorbitant amount of time and
10 expense with its fair value argument is also without merit. RUCO Br. at 9. To begin
11 with, RUCO has not cited any evidence whatsoever to illustrate the impact this legal
12 position had on rate case expense. Moreover, as clearly seen from the Company's initial
13 closing brief, the Company's assertion that it is entitled to earn a fair rate of return on its
14 fair value rate base is supported by an overwhelming body of law. Company Br. at 4-26.
15 The mere fact that RUCO now disagrees with the Company's legal arguments does not
16 mean that those arguments are incorrect.¹⁰

17 Of course, if RUCO were correct that the Company's rate case expense is high due
18 to these factors, the Company shareholders are the ones responsible. Indeed, RUCO never
19 comes to grip with the fact that the evidence in this case reflects that narely half of the
20 total rate case expense incurred by the Company will be absorbed by the utility and its
21 shareholder because the Company has only sought to recover \$715,000. In this light,
22 RUCO's continued assertion that the Commission would be sanctioning an "open
23 checkbook policy" is frivolous. RUCO Br. at 7.

24
25 ¹⁰ Compare, e.g., *Residential Utility Consumer Office, supra* (holding that the
26 Commission unlawfully authorized a surcharge to allow a water utility to recover Central
Arizona Project water delivery charges in the absence of finding the utility's fair value
rate base).

1 Ultimately, RUCO's entire argument regarding rate case expense is nothing more
2 than a strained effort to justify its own number. However, despite RUCO's
3 representations, it has not "considered what would be a fair amount of rate case expense
4 under the circumstances." RUCO Br. at 9. RUCO's number is derived solely by taking
5 the rate case expense in the last Citizens' rate case and adjusting it for inflation. Tr. at
6 812. This method is simplistic and ignores all of the unique characteristics of the two
7 cases. It also selectively ignores the fact that the Commission authorized rate case
8 expense of \$165,000 in the last rate case for the Mohave districts decided in 1990. *See*
9 Ex. S-4, Decision No. 56806 (February 1, 1990) at 10-11. Had RUCO used that prior
10 Citizens' rate case, made an adjustment for inflation and the greater number of district (10
11 versus 2), it would have resulted in a far greater amount than the amount the Company is
12 now requesting. Tr. at 1598. In short, RUCO's analysis does not in any way result in a
13 fair level of rate case expense and, for all the reasons testified to by Mr. Stephenson and
14 discussed in the Company's initial brief, the Company's request to recover \$715,000 of
15 rate case expense is reasonable under the circumstances in this case.

16 **2. A Five-Year Amortization Period is Unwarranted.**

17 Although it does not contest the Company's request to recover \$715,000 of rate
18 case expense, Youngtown recommends that the Commission reject the three-year
19 amortization period supported by all other parties in favor of a five-year amortization
20 period. In response to Youngtown's recommendation regarding rate case expense
21 amortization, Mr. Stephenson explained that the Company is likely to file its next rate
22 case at the earliest possible date. Stephenson Rb. (Ex. A-74) at 24-25. This means a rate
23 case will be filed no later than early 2006, when the current moratorium on rate increase
24 applications imposed by the Commission expires. In contrast, Youngtown cites only the
25 past record of Citizens with respect to the timing of rate case filings. Youngtown Br. at
26 15. However, Citizens' track record is irrelevant.

1 **C. RUCO's Property Tax Expense Methodology Must Be Rejected, Again.**

2 RUCO witness Tim Coley, who supported RUCO's property tax expense
3 recommendation, admitted that RUCO's position is identical to RUCO's recommendations
4 in recent rate cases. Tr. at 559. He further admitted the Commission has rejected RUCO's
5 position. *Id.*; see also, *Arizona Water Company*, Decision No. 64282 (Dec. 28, 2001).
6 Since RUCO offers no change in the facts or law, the Commission should do so again.

7 **IV. COST OF CAPITAL AND RATE OF RETURN.**

8 **A. Capital Structure and Cost of Debt.**

9 Staff is the only party (other than Arizona-American) to address the Company's
10 capital structure and cost of debt in its brief. Staff Br. at 13-14. As discussed in the
11 Company's initial brief, however, Staff again fails to recommend a capital structure that
12 contains specific amounts of debt and equity, but rather advocates the adoption of
13 percentages of each component of the Company's capital structure, which are used to
14 compute a weighted cost of capital on a Company-wide basis. That cost of capital is then
15 used as the rate of return and is applied to the OCRB for each water and wastewater
16 district to derive Staff's revenue requirement. *E.g.*, Reiker Sb. (Ex. S-46), Schedule JMR-
17 S8 (Staff's recommended capital structure); Carlson Dt. (Ex. S-47) at 8 ("Operating
18 income should be calculated by applying the recommended cost of capital to the
19 [OCRB].").

20 Staff argues that its recommended capital structure as well as its cost of debt should
21 be approved simply because those recommendations are "based on information provided
22 by Arizona-American." Staff Br. at 13-14. However, it is impossible to determine
23 whether Staff has correctly utilized the information furnished by the Company because
24 Staff has failed to provide the specific amounts of debt and equity in its proposed capital
25 structure. As explained in the Company's initial brief, Staff determined that the
26 Company's rate applications were deficient for precisely this reason. Company Br. at 42.

1 Staff's position also reinforces the fallacy underlying Staff's so-called "economic"
2 arguments in favor of using the "backing in" method to establish the return on the fair
3 value rate base for each district. As explained on pages 20-21, above, Staff uses
4 percentages of debt and equity to determine the cost of capital, rather than the actual
5 dollar amounts, because the utility's actual investment is not relevant under Staff's
6 methodology. The rate of return is determined independently of the utility's rate base. *Id.*
7 This approach also enables Staff to contend that its recommended rates of return on each
8 district's fair value rate base is sufficient to produce a pre-tax interest coverage ratio in
9 excess of 3.0 when Staff's recommendations will actually result in a pre-tax interest
10 coverage ratio of slightly over 1.0. *Compare* Stephenson Rb. (Ex. A-74), Rebuttal
11 Schedule 4, page 1 (showing calculation of pre-tax interest coverage) *with* Reiker Sb. (Ex.
12 S-46), Schedule JMR-S8 (showing Staff's calculation of pre-tax interest coverage).

13 **B. Arizona-American's Recommended Cost of Equity Is Reasonable and**
14 **Should Be Adopted.**

15 There is no disagreement that the methods used by the cost of capital witnesses for
16 the Company, Staff and RUCO, the DCF model – the Risk Premium model and the
17 CAPM model – are all recognized methods of estimating the cost of equity. *E.g.*, Roger
18 A. Morin, *Regulatory Finance: Utilities Cost of Capital* 28 ("There are four generic
19 methodologies available to measure the cost of equity: DCF, Risk Premium, and CAPM,
20 which are market-oriented, and Comparable Earnings, which is accounting oriented.").
21 There is considerable disagreement, however, regarding how these methodologies should
22 be employed. As the Arizona Utility Investors Association has pointed out in its brief, the
23 manner in which Staff's witness, Mr. Reiker, has chosen to implement the DCF model
24 and the CAPM in arriving at his recommended 9.0% equity return is designed to produce
25 the lowest possible results. AUIA Br. at 8-9. *See also* Tr. at 1423-30. Using Mr.
26 Reiker's models and their inputs, but applying more reasonable assumptions, Dr. Zepp

1 demonstrated that Staff's recommended equity return for Arizona-American is
2 understated by more than 100 basis points. See Zepp Rj. (Ex. A-50) at 10-14 and
3 Rejoinder Table 14.

4 Perhaps more importantly, putting aside the technical arguments presented by Mr.
5 Reiker, his cost of equity estimates are simply not consistent with recent authorized
6 returns on common equity, realized returns on common equity, and *Value Line's*
7 forecasted returns on common equity for the sample group of publicly traded water
8 utilities. As discussed in the Company's initial brief, the manner in which the DCF and
9 CAPM models have been implemented by Mr. Reiker (as well as by Mr. Rigsby, RUCO's
10 cost of capital witness) produce equity cost estimates substantially *below* the actual and
11 forecasted returns on equity for the water utility sample group. Company Br. at 48-51.

12 As Mr. Meek testified:

13 Simple common sense warns that something is wrong with
14 models that produce such low results compared to actual
15 returns in the market. Mr. Reiker does not really explain how
this disconnect occurs. He simply accepts the result
produced.

16 Meek Rb. (Ex. AUIA-1) at 11. When Mr. Reiker's particular version of the CAPM
17 produces a cost of equity of only 8.1% while the sample group of publicly traded water
18 utilities are actually earning returns substantially in excess of 10% and are forecasted by
19 *Value Line* to earn 11.0% on common equity in 2004, something is plainly wrong.

20 **1. Staff's Criticisms of Dr. Zepp's DCF Model Estimates Are**
21 **Groundless.**

22 A number of Staff's criticisms of Dr. Zepp's cost of equity estimates are simply red
23 herrings that are irrelevant. Staff contends that Dr. Zepp "improperly excluded"
24 Connecticut Water and Middlesex Water from his water utility proxy group. Staff Br. at
25 14-15. Contrary to Staff's representations, however, Dr. Zepp explained that he excluded
26

1 those two utilities in preparing his direct testimony in 2002¹¹ because their stock prices
2 had increased dramatically between 1999 and 2002 and, as a consequence, these
3 companies appeared to be merger or acquisition targets. Zepp Dt. (Ex. A-44) at 13-14. In
4 fact, this is borne out by the record. The total shareholder return (dividends plus
5 appreciation in stock price) for the two companies as of September 30, 2003, is as
6 follows:

	<u>3-Year Total Return</u>	<u>5-Year Total Return</u>
8 Connecticut Water	37.6%	90.0%
9 Middlesex Water	40.8%	110.2%

10 Ex. A-83. Thus, an investor in the stock of these two utilities would have earned, on
11 average, a return in excess of 13% per year over a three-year period, and a return in excess
12 of 20% per year over a five-year period.¹²

13 Because of this rapid appreciation in stock price, Dr. Zepp excluded Connecticut
14 Water and Middlesex Water in performing his DCF and Risk Premium estimates. *See*
15 Zepp Rb. (Ex. A-49) at 7-9. Staff contends that these two utilities should have been used.
16 Regardless of who is right, it ultimately makes no difference. As Dr. Zepp testified,
17 Middlesex Water has an estimated equity cost of 10.5% (Zepp Rb. (Ex. A-49) at 8), while
18 both utilities currently have returns on equity substantially in excess of Staff's
19 recommendation. Ex. A-98.¹³ Moreover, in restating Mr. Reiker's DCF equity cost
20 estimates, Dr. Zepp included both water utilities. Zepp Rj. (Ex. A-50) at 17.

21
22 ¹¹ Arizona-American's rate applications were filed for nine of the 10 water and
wastewater districts in November 2002, while the application for the Tubac water district
was filed in December 2002.

23 ¹² According to Mr. Reiker, these are the returns that utility investors such as Mr. Meek
24 should be primarily concerned about. Obviously, Mr. Meek would have done quite well if
25 he had had the foresight to invest in Connecticut Water and Middlesex Water in the Fall
of 1998.

26 ¹³ Connecticut Water's current return on equity is 11.4%, while Middlesex Water's
current return on equity was 9.6%. Ex. A-98.

1 Similarly, Staff criticizes Dr. Zepp for using 3-month and 12-month average stock
2 prices to compute dividend yields in his DCF estimates. Staff Br. at 15-16. First, in
3 updating his cost of equity estimates in his rebuttal testimony, Dr. Zepp did *not* use 12-
4 month average stock prices. See Zepp Rb. (Ex. A-49), Update Tables 8 and 14. Second,
5 while Staff claims that “the best forecast of tomorrow’s yield is simply today’s yield,” Mr.
6 Reiker used stock prices as of September 25, 2003, which are already nearly five months
7 old and will be even more outdated by the time the Commission issues its decision. See
8 Reiker Sb. (Ex. S-46), Schedule JMR-S5. Finally, once again, Dr. Zepp used Mr.
9 Reiker’s spot prices in restating Mr. Reiker’s DCF equity cost estimates. Zepp Rj. (Ex.
10 A-50) at 18 and Rejoinder Tables 3 and 4.

11 Ultimately, the primary difference between the Company and Staff is the method
12 chosen to estimate growth rates. Dr. Zepp relied on near-term earnings and sustainable
13 growth in his constant growth DCF model estimates, and did not consider dividend per
14 share (“DPS”) growth and historic earnings per share (“EPS”) growth because, as Dr.
15 Zepp has discussed at length, these measures of growth are substantially less than other
16 recognized measures of dividend growth. E.g., Zepp Rb. (Ex. A-49) at 42-47; Zepp Rj.
17 (Ex. A-50) at 19-21; Tr. at 322. For the water utility sample, EPS growth is expected to
18 be three times faster than DPS growth. For the gas utility sample, EPS are expected to
19 grow six times faster than DPS. Zepp Rb. (Ex. A-49) at 43. In addition, during the past
20 five years, average prices for water utility stocks have increased faster than EPS, DPS and
21 book value. *Id.* at 44 and Rebuttal Table 6. Dr. Zepp explained that this growth in prices
22 would cause investors to expect more rapid growth in the future than in the past –
23 otherwise, investors would not bid up the price of the stock. *Id.* He also showed that the
24 use of historic and forecasted DPS growth in the constant growth DCF model would
25 produce equity cost estimates in the range of 6.5% to 7.4% – a result below the rate for
26 Baa-rated bonds forecasted for 2004. Zepp Rb. (Ex. A-49) at 46-47.

1 By simply restating the growth component of Mr. Reiker's constant growth DCF
2 equity cost estimates to eliminate historic and forecasted DPS growth, Mr. Reiker's DCF
3 model produced equity cost estimates that averaged 9.8% and 10.0% at the time Dr. Zepp
4 prepared his rebuttal testimony, and 9.8% and 9.9% when Dr. Zepp prepared his rejoinder
5 testimony. Zepp Rb. (Ex. A-49), Rebuttal Tables 10 and 11; Zepp Rj. (Ex. A-50), Tables
6 3 and 4. With the inclusion of an additional 50 basis points to account for leverage (which
7 is not in dispute), the indicated equity cost for Arizona-American, using Mr. Reiker's own
8 methodology, ranges from 10.3% to 10.5% – substantially greater than Mr. Reiker's 9.0%
9 recommendation.

10 Staff's attack on Dr. Zepp's restatement of Mr. Reiker's multi-stage DCF model is
11 also misguided. Mr. Reiker improperly used a two-stage DCF model that assumes
12 investors would look at dividend growth for five years ("stage 1") and then adopt a
13 growth rate for the economy as a whole for the terminal growth rate ("stage 2"). Zepp Rb.
14 (Ex. A-49) at 47-48. As explained by Dr. Zepp:

15 Knowledgeable investors expect the relatively slow near-term
16 growth in DPS will be rewarded by higher future growth as
17 the utilities gain financial strength from growing their
18 earnings retention ratios. A multi-stage growth DCF model
19 should incorporate this reasonable expectation of investors
and not immediately go to a final stage growth rate that has
nothing to do with the improved financial strength of the
utilities.

20 *Id.* at 48. Staff also criticizes Dr. Zepp for using *Value Line* forecasts of intrinsic or
21 sustainable growth to determine second-stage growth in Dr. Zepp's more sophisticated,
22 three-stage restatement of Mr. Reiker's model. Staff Br. at 17. However, Mr. Reiker's
23 two-stage version of the model is far more speculative because it (1) ignores known
24 forecasted growth for the water utilities included in Mr. Reiker's constant growth DCF
25 analysis (but not in his multi-stage analysis¹⁴), and (2) assumes that an economy-wide

26 ¹⁴ Ironically, Staff criticizes Dr. Zepp for not including Connecticut Water and Middlesex

1 growth rate will apply to the utility sample group as early as 2009. *Id.* at 48-49; Zepp Rj.
2 (Ex. A-50) at 21 and 23. Notably, Dr. Zepp's approach is supported by Professor Myron
3 Gordon, who is acknowledged by Mr. Reiker to be an authority on the DCF model. Zepp
4 Rj. (Ex. A-50) at 21-22 and Exhibit TMZ-RJ-2 (communication from Professor Gordon);
5 Reiker Dt. (Ex. S-45) at 10, 15, 41 and 50 n.50.

6 **2. Staff's CAPM Equity Cost Estimates Are Unreasonably Low and**
7 **Should Be Rejected.**

8 Staff begins its discussion of its CAPM estimates by stating that the "CAPM, the
9 work of Nobel Prize winning economists, is the best-known model of risk and return."
10 Staff Br. at 17 (citing Reiker Dt. (Ex. S-45) at 21). In fact, Mr. Reiker's statement is taken
11 out of context and is misleading. The entire statement, which is found in a well-known
12 college finance textbook, is actually as follows:

13 The capital asset pricing theory is the best-known model of
14 risk and return. It is plausible and widely used but far from
15 perfect. Actual returns are related to beta over the long run,
16 but the relationship is not as strong as the CAPM predicts,
17 and other factors seem to explain returns better since the mid-
1960s. Stocks of small companies, and stocks with high book
values relative to market prices, appear to have risks not
captured by the CAPM.

18 Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* 212 (6th ed.
19 2000). This is another source Mr. Reiker regards as authoritative. Reiker Dt. (Ex. S-45)
20 at 6, 21, 30, 34 and 59 (citing textbook).

21 The publicly traded water utilities in Staff's sample group are all small companies.
22 Philadelphia Suburban is by far the largest water utility in the sample group, with net
23 utility plant of nearly \$1.4 billion and operating revenue in excess of \$400 million, as well
24

25 Water in his water utility sample group, while Mr. Reiker has excluded both of those
26 water utilities as well as SJW Corp. from his water utility sample group in performing his
multi-stage DCF estimate.

1 as operations in 15 states. Ex. A-100. Philadelphia Suburban is nevertheless considered a
2 "Mid Cap" stock, while the remaining five water utilities are considered "Small Cap"
3 stocks. Ex. A-83. In other words, the companies in the water utilities sample group fall
4 within the category of stocks that "appear to have risks not captured by the CAPM," i.e.,
5 the results of the basic CAPM *understate* their equity cost. Moreover, as Dr. Zepp
6 explained, the stocks of small companies that are thinly traded on the market are expected
7 to have betas that are biased downward, which again understates the equity cost produced
8 by the CAPM. Zepp Dt. (Ex. A-44) at 46-47; Zepp Rb. (Ex. A-49) at 11 and 34-35.¹⁵

9 Given these problems with the CAPM generally and in applying this model to the
10 sample groups of utilities used in this case, it is little wonder that Mr. Reiker's CAPM
11 estimates are extremely low: *only 8.1%*. Reiker Sb. at 2 and Schedule JMR-S7. Mr.
12 Rigsby's revised CAPM estimate is not much better, only 8.75%. Rigsby Sb. (Ex. R-6) at
13 7. Neither Mr. Reiker nor Mr. Rigsby provides any explanation for the extremely low
14 result produced by his particular version of the model. Moreover, Mr. Reiker has
15 employed a version of the model that is extremely volatile and produced dramatically
16 different results over a period of several months. Between the time Staff filed its direct
17 and its surrebuttal testimonies, Mr. Reiker's indicated cost of equity decreased from
18 11.1% to only 8.1%. *Compare* Reiker Dt. (Ex. S-45), Schedule JMR-S8 *with* Reiker Sb.
19 (Ex. S-46), Schedule JMR-S7. This dramatic decrease occurred despite the fact that Mr.
20 Reiker used an intermediate-term Treasury spot rate that was actually 30 basis points
21 *higher* when the second CAPM equity cost estimate was made. *Id.* Once again,
22 something is clearly wrong.

23 Both Mr. Reiker and Staff in its brief contend that Professor William Sharpe is an

24
25 ¹⁵ As a result, Philadelphia Suburban, the largest and most geographically diverse water
26 utility in the sample group, has a substantially higher beta than Middlesex Water and SJW
Corp., whose stocks are infrequently traded. Ex. A-100.

1 authority on equity cost estimation techniques. Staff Br. at 19.¹⁶ As Dr. Zepp has
2 explained, Professor Sharpe now believes that a different version of the CAPM, known as
3 the “zero-beta” CAPM, provides a better explanation of stock prices, and the version of
4 the CAPM used by Mr. Reiker (and Mr. Rigsby) understates the expected return on the
5 risk-free asset used in the model. Zepp Dt. (Ex. A-44) at 45 n. 14; Zepp Rb. (Ex. A-49) at
6 39-41. Other tests of the CAPM also indicate that versions of the model Staff and RUCO
7 have used are biased downward. Zepp Rb. (Ex. A-49) at 38-39. Given the uncertainty
8 surrounding the versions of the CAPM used by Staff and RUCO, the problems with
9 estimating the betas for small water utility stocks, the low results produced by their
10 versions of the CAPM (8.1% and 8.75%, respectively), and the fact that Arizona-
11 American is not publicly traded and has no beta, the Staff and RUCO CAPM equity cost
12 estimates must be rejected.

13 **3. The Risk Premium Method Provides a Direct and More**
14 **Objective Estimate of the Current Cost of Equity Than the**
15 **CAPM.**

16 Because of the problems in implementing the CAPM, few regulatory commissions
17 give the CAPM much weight when determining equity costs. Zepp Rb. (Ex. A-49) at 39-
18 40. The preferred method to implement the CAPM is to estimate the equity cost using a
19 risk premium approach, as Dr. Zepp has done. Under that approach, the risk premium is
20 directly estimated by comparing authorized and actual returns on equity with rates on
21 bonds or other debt instruments. Under the risk premium approach, “there is no need to
22 estimate betas or market risk premiums, and there is no reason to determine if ‘beta risk’
23 is the only risk of relevance to investors holding shares of water utilities. It is a simpler
24 and less subjective approach.” *Id.* at 40.

25 Staff argues that Dr. Zepp’s risk premium cost of equity estimates should be

26 ¹⁶ In fact, Professor Sharpe was a co-winner of the Nobel Prize for his work in developing
the initial version of the CAPM in the mid-1960s. Brealey and Myers, *supra*, at 195.

1 rejected because, first, he has relied on forecasts of Baa corporate bond rates. Staff Br. at
2 18. Staff argues that "current" interest rates (i.e., interest rates as of September 2003)
3 provide a more accurate indication of interest rates during the second half of 2004 and
4 2005 – the time period during which new rates will be in effect – than forecasted rates.
5 Dr. Zepp explained why this argument is erroneous. *E.g.*, Zepp Rj. (Ex. A-50) at 23-26.

6 There are basically three approaches that can be taken. One
7 is Mr. Reiker's approach, adopt current interest rates and
8 assume they are the best forecast of next year's rates. The
9 second is to adopt published forecasts of interest rates. Third
10 is to derive forward rates for 2004 from current short-term
rates and current intermediate-term rates. Of the three, the
approach Mr. Reiker has taken creates the most uncertainty
and the greatest chance that the cost of equity will be
understated.

11 *Id.* at 24. Dr. Zepp provided evidence showing that interest rates increased in 2003 and
12 are forecasted to be even higher in 2004. *Id.*, Rejoinder Table 6 (comparing current and
13 forecasted treasury rates). In his Direct Testimony, Mr. Reiker stated that interest rates
14 "are currently at their lowest level since the 1950's." Reiker Dt. (Ex. S-45) at 5. Since
15 Mr. Reiker filed that testimony, however, the average of intermediate-term Treasury rates
16 increased by 50 basis points. *Id.* at 2 and Rejoinder Table 6.¹⁷ It is unreasonable to
17 assume that interest rates will remain indefinitely at last summer's levels, as Mr. Reiker
18 does.

19 Staff also argues that Dr. Zepp's risk premium approach is flawed because Baa
20 corporate bond rates include a default premium. Staff Br. at 19 Dr. Zepp explained that
21 this is another red herring. Whether or not there is a default premium in Baa bond rates
22 does not matter if the same default premium that existed in the past is expected in the
23 future. Zepp Rj. (Ex. A-50) at 26. He also explained that the quotation from Professor

24
25 ¹⁷ At the same time, however, Staff's recommended equity cost decreased by 70 basis
26 points, from 9.7% to 9.0%. Apparently, as interest rates go up, equity costs go down.
Compare Reiker Dt. (Ex. A-45) at 6 ("According to the [CAPM], the cost of equity moves
in the same direction as interest rates.").

1 Sharpe in Mr. Reiker's Surrebuttal Testimony (referenced in Staff's brief) does not apply
2 to the analysis Dr. Zepp presented because the analysis already takes into account the
3 existence of a risk premium. *Id.* at 26-27. This is supported by Dr. Morin's view that
4 "the choice of debt instrument in the risk premium analysis is largely immaterial, as long
5 as it is consistently applied." Morin, *supra*, at 278.

6 Dr. Zepp provided empirical data demonstrating that Baa corporate bond rates
7 provide more reliable estimates of the cost of equity than Treasury rates. Zepp Rb. (Ex.
8 A-49) at 22-23 and Rebuttal Tables 2 and 3. The validity of Dr. Zepp's risk premium
9 method is also supported by the fact that his estimated equity costs for the sample group
10 of publicly traded water utilities range from 10.3% to 11.2% – a range that is consistent
11 with the authorized, actual and forecasted returns on equity for those utilities. This range
12 is far more reasonable than Staff's CAPM equity cost estimate of 8.1%.

13 **V. RATE DESIGN.**

14 **A. Staff's Proposed Rate Design will not Promote Conservation.**

15 In its initial brief, the Company discussed at some length the various defects in
16 Staff's proposed three-tier, inverted block rate structure, which, as Staff's rate design
17 witness admitted, will not reduce consumption by existing customers and will primarily
18 impact *future* commercial and industrial customers. Company Br. at 56-60; Tr. at 1099-
19 101 and 1114-15. Nevertheless, Staff argues, with no legitimate basis, that its rate design
20 "targets conservation." Staff Br. at 11. This is simply not accurate. In reality, Staff's
21 proposed rate design will fail to send a price signal to all but the largest customers while
22 providing discounted rates to the majority of Arizona-American's customers because the
23 *same* break-over points would apply to all customers, regardless of the type of use and
24 meter size.

25 Staff argues that its first tier appropriately recognizes that a certain level of water
26 usage is "non-discretionary" because it is needed for health and safety. Staff Br. at 10.

1 However, this argument simply misses the point. Every customer will be entitled to
2 receive service at a discounted rate for all usage within that block, i.e., a rate that is below
3 the cost of service. Selling water below cost does not encourage water use efficiency, as
4 Staff claims. Kozoman Rb. (Ex. A-62) at 4-5. A substantial portion of many residential
5 customers' monthly usage will fall in this block, thus creating an incentive to use more,
6 not less, water. *Id.* at 6, *quoting* American Water Works Association, *Alternative Rates*
7 11 (attached as Rebuttal Exhibit 1). As an example, the following table shows the
8 percentage of usage in Staff's initial discounted rate block for an average residential
9 customer being served by a 5/8 inch meter.

	<u>Average Usage</u>	<u>Percentage of Use in Initial Block</u>
11 Agua Fria	7,002 gal.	57%
12 Anthem	10,212 gal.	39%
13 Havasu	7,650 gal.	52%
14 Mohave	8,787 gal.	46%
15 Sun City	8,361 gal.	49%
16 Sun City West	7,171 gal.	56%
17 Tubac	13,177 gal.	30%

18
19 Kozoman Rj. (Ex. A-63), Rejoinder Schedules H-2. The vast majority of customers will
20 have their monthly bills reduced by virtue of this rate design.

21 At the same time, however, very few residential customers will have monthly water
22 usage that exceeds the 100,000 gallon break-over point separating Staff's middle and
23 upper commodity rate tiers.¹⁸ In fact, many commercial customers on smaller size meters
24 likewise do not use more than 100,000 gallons each month. Tr. at 1093. All of these

25
26 ¹⁸ Between 88% and 92% of the Company's customers in each water district are residential. Tr. at 419.

1 customers will benefit by receiving their first 4,000 gallons of water each month at a
2 discounted rate. However, because the break-over point between the second and third
3 tiers has been set at 100,000 gallons, they will not receive any sort of price signal that will
4 encourage conservation. For example, a single-family residential customer could use an
5 average of 83,333 gallons of water per month, or a total of 1 million gallons of water
6 annually, and never be subject to the higher commodity rate in Staff's upper tier.

7 As a consequence, as Mr. Kozoman testified, while Staff's rate design may have
8 three inverted tiers, it is not a conservation-oriented rate structure. Kozoman Rb. (Ex. A-
9 62) at 27. *See also* Tr. at 1301-02. "The simple fact is that Staff's rate design is intended
10 to shift the recovery of revenues to larger sized meters, in violation of cost of service
11 principles, and not to achieve conservation or any societal goals." Kozoman Rj. (Ex. A-
12 63) at 5. Mr. Rogers admitted that only a "small minority" of customers would actually
13 be impacted by the 100,000 gallon break-over point. Tr. at 1092-93. In its brief, Staff
14 similarly states that its rate design is intended to have a limited effect on existing
15 customers. Staff Br. at 11. Far from standing "front and center" (Staff Br. at 11),
16 conservation is cowering in the broom closet. Consequently, this rate design must be
17 rejected.

18 **B. Staff's Criticisms of the Company Are Without Merit.**

19 Staff claims that Arizona-American has ignored "the plethora of evidence in
20 support of Staff's rate design" and remains "defiant in its objections." Staff Br. at 11-12.
21 This is, of course, nonsense given the dearth of evidence Staff has presented. The bottom
22 line is that Staff has proposed an extremely poor rate design that, by Mr. Rogers' own
23 admission, is unlikely to have any immediate effect on consumption. *E.g.*, Tr. at 1096.

24 This same sort of rate structure was proposed by Staff in the rate proceeding for
25 Arizona Water Company's Northern Group water systems and was rejected by the
26 Commission. Decision No. 64282 (Dec. 28, 2001) at 21-22. A similar rate design was

1 proposed by Staff in that water utility's pending rate proceeding for its Eastern Group
2 water systems, and in the Administrative Law Judge's recommended order, Staff's rate
3 design was again rejected. Recommended Opinion and Order, Docket No. W-01445A-
4 02-0619 (filed Jan. 2, 2004) at 24-26. *See also* Tr. at 1068-71 and Ex. A-90 (excerpt from
5 Direct Testimony of John S. Thornton¹⁹). As in those proceedings, Staff in this case did
6 not prepare a cost of service study or otherwise perform a detailed billing analysis in order
7 to develop appropriate break-over points and commodity rates by meter size or customer
8 class. Tr. at 1102-07. To contend that there is a "plethora" of evidence supporting Staff's
9 proposal is, at best, hyperbole.

10 Incredibly, Staff argues that the lack of support for Staff's rate design is the fault of
11 the Company. Staff points out that Arizona-American did not file any cost of service
12 studies, suggesting that this somehow hampered Staff. Staff Br. at 12. This is nonsense.
13 First, Arizona-American did not file any cost of service studies because it did not propose
14 any changes in rate design. Kozoman Dt. (Ex. A-52) at 3-4. Second, Staff had ample
15 time to prepare its own cost of service studies or perform an analysis of the Company's
16 customers and test year billings in order to develop an effective conservation-oriented rate
17 structure. The Company's rate applications were filed in November 2002, and were found
18 sufficient in January 2003. *See* Letter of Sufficiency (docketed Jan. 30, 2003). Staff's
19 direct testimony was not filed until September 5, 2003, which was sufficient time for Staff
20 to conduct the sort of analysis required to support its proposed rate design. Third, the
21 Company *did* perform cost of service studies for each of its water districts as part of its
22 rebuttal filing, using Staff's recommended revenue and rate design. Kozoman Rb. (Ex. A-
23 62) at 9-17 and Rebuttal Schedules G-1 through G-9. In short, Staff cannot blame the
24 Company for the defects in Staff's rate design.

25
26 ¹⁹ Staff's rate design witness in Arizona Water Company's Eastern Group rate case was Mr. Thornton.

1 Staff also complains in a footnote on page 12 of its brief that Arizona-American
2 "failed" to provide Staff and the other parties with its suggested alternative form of rate
3 design "until January 23, 2004." The Company developed this alternative following the
4 evidentiary hearing, which concluded on December 23, 2003. Despite the holidays, the
5 Company was able to develop inverted-tier rate designs for each of the seven water
6 districts that differentiate among different classes of customers and different size meters.
7 Company Br. at 60-64 and schedules attached at Tab A. *See also* Sun Health Br., attached
8 memorandum from Arizona-American. Put bluntly, the Company did in 30 days
9 following the hearing what Staff was unable to do during the 12 months preceding the
10 hearing.

11 Finally, Staff states that it identified "problems" regarding the existing rate designs
12 for multi-unit commercial customers served by the Mohave and Havasu water districts.
13 However, according to Staff, because Arizona-American did not submit cost of service
14 studies, Staff could not recommend any "wholesale" changes to the rate design for those
15 customers. Staff Br. at 13. Again, this criticism is groundless. First, as Mr. Kozoman
16 testified, Citizens proposed changes to its rate design to address multi-unit commercial
17 customers in its prior rate case for the Mohave water district. However, Staff
18 recommended that the current rate design be retained, and the Commission adopted
19 Staff's recommendation. Kozoman Rb. (Ex. A-62) at 28. Second, Staff certainly had
20 ample time to develop an alternative rate design for multi-unit commercial customers in
21 those two water districts, and simply chose not to do so. Third, as stated above, Arizona-
22 Arizona did file cost of service studies based on *Staff's* recommended revenue and rate
23 design, which should have allowed Staff to develop a recommendation. There is no
24 evidence in the record suggesting that Arizona-American's failure to file cost of service
25 studies impaired or hindered Staff's ability to develop an alternative rate design over the
26

1 past year, and Staff's attacks on Arizona-American are unwarranted.²⁰

2 C. Youngtown's Request for a Stepped Rate Increase is Unlawful.

3 In its brief, Youngtown has requested that the Commission phase in any rate
4 increase for the Sun City water and wastewater districts in two or three steps: two equal
5 steps if the rate increase is between 20% and 40%, and three equal steps if the increase is
6 greater than 40%. Youngtown Br. at 14. This request is unlawful because it would
7 deprive Arizona-American of a fair return on its rate base.

8 As authority for this request, Youngtown cites *Arizona Comm. Action Ass'n v.*
9 *Arizona Corp. Comm'n*, 123 Ariz. 228, 599 P.2d 184 (1979). That case, however, does
10 not allow the Commission to determine the fair value of a utility's plant and property,
11 establish a rate of return to be earned on fair value, and then deny the utility the right to
12 recover that return by phasing in the required rate adjustments. Instead, the court held that
13 it was lawful for the Commission to authorize future rate increases based on construction
14 work in progress ("CWIP") related to the Palo Verde nuclear generation facility, which
15 was then under construction. The court found it "entirely reasonable" for the
16 Commission to allow the inclusion of CWIP in rate base and to allow APS to receive
17 "step" rate increases based on CWIP. *Arizona Comm. Action*, 123 Ariz. at 230-31, 599
18 P.2d at 186-87. The court stated that the "adjustments ordered by the Commission in
19 adding CWIP to th[e] determination of fair value were adequate to maintain a reasonable
20 compliance with the constitutional requirements if used for only a limited period of time,"
21 i.e., until a new rate case was filed by APS. *Id.* at 231, 599 P.2d at 187. However, the
22 court did not hold, or otherwise suggest, that it would be permissible for the Commission
23 to withhold rate increases determined necessary to produce a reasonable on the fair value
24 of APS's property. *Compare, e.g., Scates*, 118 Ariz. at 534, 578 P.2d at 615 ("the rates

25 ²⁰ It should be noted that Arizona-American has not opposed modifying the rates for
26 multi-unit commercial customers in the Mohave and Havasu water districts. Kozoman
Rb. (Ex. A-62) at 28. The decision not to do so was made entirely by Staff.

1 cannot be considered just and reasonable if they fail to produce a reasonable rate of
2 return”).

3 Youngtown also seems to suggest that if the Commission were to conclude that it is
4 indeed illegal to deprive the Company of a reasonable return by phasing in the rate
5 increases, then the Commission should simply cap the increase based on Youngtown’s
6 proposed phasing. Youngtown Br. at 15. This would also be illegal because, if adopted,
7 it would effectively limit Arizona-American to a maximum revenue increase of 20% for
8 each district, regardless of whether that increase would actually produce a reasonable rate
9 of return on fair value. Youngtown offers no authority for this remarkable request, other
10 than suggesting it would be fair to do so. This would be contrary to Arizona law and
11 amount to confiscation of Arizona-American’s property, as the Arizona appellate decision
12 discussed at pages 12-14, above, clearly hold. In short, the Commission should reject
13 Youngtown’s attempt to rewrite Arizona law and override the Constitution.

14 D. Recovery of Increased Costs Under the Tolleson Agreement Should Not
15 Be Denied.

16 In its closing brief, RUCO asserts that the Company should not be allowed to
17 recover increased Tolleson costs under the Third Amendment because it has an
18 accounting order that authorizes the Company both accrual *and* recovery. RUCO Br. at
19 12. This is simply erroneous. In fact, Ms. Diaz Cortez testified that the accounting order
20 does not guarantee or ensure any recovery of costs by Arizona-American. Tr. at 742. *See*
21 *also* Tr. at 1470.

22 Staff’s arguments in favor of denying cost recovery are equally unpersuasive.
23 First, Staff asserts that Mr. Bourassa agreed that the Tolleson costs are not known and
24 measurable. Staff Br. at 9. This misstates the record. In the portion of the transcript Staff
25 cites, Mr. Bourassa was asked on cross-examination if the Tolleson costs under Rate
26 Component Four were sufficiently “known and measurable” for a pro forma adjustment.

1 Mr. Bourassa explained that he was not recommending such an adjustment. Tr. at 146-47.
2 Staff ignores Mr. Bourassa's earlier testimony when Staff actually asked whether the costs
3 under Rate Component Four were "known and measurable." Tr. at 145. In response to
4 that inquiry, Mr. Bourassa explained that the liability was known now and that the costs
5 would be fully known and measurable at the time ratepayers pay for them through rates.
6 *Id.* The very purpose of the "known-and-measurable" standard is to ensure, as nearly as
7 possible, that expenses like these are not under or over-collected. As Mr. Bourassa
8 explained, under the Company's proposed recovery mechanism, ratepayers would pay
9 only for costs at the time they are "known and measurable." Tr. at 146-46.

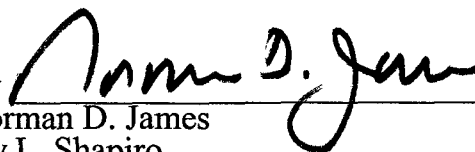
10 Staff's argument that Arizona-American has sufficient control over these costs to
11 justify the denial of cost recovery also fails. Staff Br. at 9. Staff witness Darron Carlson
12 testified that the Company has "very little input" on the level of plant investment Tolleson
13 will make. Tr. at 1473. Nevertheless, the Staff's engineering witness, Dorothy Haines,
14 testified that these costs were not only necessary, but would benefit ratepayers when
15 compared to the cost of designing and constructing a new treatment plant. Tr. at 1152-54.
16 Mr. Bourassa testified that the Company can tell Tolleson that it believes the costs are too
17 high, but has no control over Tolleson's final decision. Tr. at 155-56 and 208-09. The
18 contract itself provides Arizona-American nothing more than the right of engineering
19 input. Ex. S-1. Obviously, input is not equivalent to control. Therefore, there is no
20 evidence to support Staff's claim that the Company has "control" over the costs Arizona-
21 American must incur under its agreement with Tolleson.

22 Finally, Staff's argument that the recovery mechanism is too complex must be
23 rejected. Staff Br. at 9. Staff has not cited any evidence that the mechanism is complex.
24 Instead, Staff counsel merely asked Mr. Bourassa whether he designed it to be simple.
25 Staff Br. at 9, *citing* Tr. at 161. Mr. Bourassa actually testified he thought the adjuster
26 was simple enough. Tr. at 161. Customers will simply see a line item on their bill for the

1 Tolleson costs being recovered by means of the Company's cost recovery mechanism.
2 Any "complexity" is the result of the Company designing the cost recovery mechanism to
3 spread the expense over the remaining life of the Tolleson Agreement, rather than filing
4 rate applications each year to recover the costs the Company must pay Tolleson to receive
5 wastewater treatment service. Arizona-American should not be deprived of recovery
6 because it has sought to minimize the impact of substantial, but necessary, expenses on its
7 customers.

8 RESPECTFULLY SUBMITTED this 18th day of February, 2004.

9 FENNEMORE CRAIG

10
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16 An original and 21 copies of the
17 foregoing and attachments
18 were delivered this 18th day of
19 February, 2004, to:

20 Docketing Supervisor
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22 Arizona Corporation Commission
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24 Phoenix, AZ 85007

25 A copy of the foregoing and attachments
26 were hand-delivered this 18th day of
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